ISRAEL

The Department of State submitted this report to the Senate Committees on Foreign Relations and on Finance and to the House Committees on Foreign Affairs and on Ways and Means, on January 31, 1999.

Key Economic Indicators

(Billions of U.S. Dollars unless otherwise indicated)

	1996	1997	1998 1/
Income, Production and Employment:			
Nominal GDP	95.2	98.1	96.3
Real GDP Growth	4.6	2.2	1.9
GDP by Sector:			
Agriculture	2.7	2.5	2.3
Manufacturing	18.0	18.2	18.1
Services	54.1	56.5	55.6
Public Sector	20.5	20.9	20.4
Per Capita GDP (US$)	16,750	16,830	16,160
Labor Force (000s) 2/	2,160	2,210	2,270
Unemployment Rate (pct) 2/	6.7	7.7	8.7
Money and Prices (annual percentage growth):			
Money Growth (M2) (pct) 3/	26	25	20
Consumer Inflation (pct) 3/	10.6	7.0	10.0
Exchange Rate (NIS/US$) 2/	3.19	3.45	3.80
Balance of Payments and Trade:			
Total Exports FOB	20.5	22.5	22.9
Exports to U.S.	6.3	7.2	8.1
Total Imports CIF 4/	29.9	29.0	28.0
Imports from U.S. 4/	6.0	5.4	5.3
Trade Balance 4/	-9.4	-6.5	-5.1
Balance with U.S. 4/	0.3	1.8	2.8
External Public Debt (gross)	25.2	26.1	28.0
Fiscal Deficit/GDP (pct)	3.6	2.8	2.3
Current Account Deficit/GDP (pct)	5.4	3.3	2.5
Debt Service/GDP (pct) 5/	6.5	6.5	6.5
Gold and Foreign Exchange Reserves 6/	11.6	20.3	22.5
Aid from U.S.	3.1	3.0	2.9
Aid from Other Countries	0	0	0

1/ 1998 indicators estimated using partial-year data.

2/ Annual average.
3/ December to December.
4/ Excludes defense imports.
5/ Includes private sector debt service.
6/ At end of year.

1. General Policy Framework

Israel is a small open economy, increasingly competitive internationally in such high technology sectors as telecommunications, software, pharmaceuticals, and biomedical equipment. Israel's economy grew rapidly in the first half of the 1990s, with growth averaging six percent annually. This expansion, during which Israel's economy grew in real terms by a cumulative 40 percent, was stimulated by a wave of immigration from the countries of the former Soviet Union and the erosion of Israel's economic isolation following peace agreements reached with Jordan and the Palestinians. Rising incomes and the needs of the immigrants encouraged a strong upsurge in imports, including from the United States. Merchandise imports almost doubled between 1990 and 1996, rising from $15.1 billion to $29.6 billion; imports from the United States grew from $2.7 billion to $6.0 billion over the same period. Export growth, although strong, did not keep pace, and the current account deficit widened to over five percent of GDP in 1996.

Since 1996, economic growth has slowed markedly; the growth rate for 1998 is estimated at only 1.9 percent. One factor behind the economic slowdown was a tightening of fiscal policy undertaken in 1997, which cut the budget deficit by roughly two percent of GDP, a tightening implemented to avert a potential crisis in Israel's balance of payments. Fiscal restraint has continued into the 1998 and proposed 1999 budgets, as the government attempts to reduce the fiscal deficit to a goal of 1.5 percent of GDP by 2001. Defense spending remains the largest single component of the Israeli budget, accounting for almost one-fifth of total spending. In recent years, the most rapidly growing portions of the budget have been in the area of social services, such as health care, education, and direct payments to individuals and institutions. Between 1990 and 1998, for example, education spending rose 83 percent after inflation, while transfer payments increased by 76 percent.

The goal of monetary policy is to reduce Israel's traditionally high inflation rate to OECD average levels by 2001. Since 1994, the central bank has maintained high real interest rates in its campaign to slow inflation and to achieve eventual price stability. Its chief policy instrument is the interest rate charged on its "monetary loans" to the commercial banks; it also adjusts domestic liquidity through purchases and sales of treasury bills, and by adjusting the volume of its borrowings from the banks. With imports of goods and services amounting to some 45 percent of GDP, Israel's inflation rate is strongly influenced by exchange rate developments. For example, after the consumer price index had risen only 3.0 percent in the twelve months ending in July 1998, the lowest rate of price increase recorded since the 1960s, a sharp decline in the value of the shekel in subsequent months gave a swift upward boost to inflation. Israel's official inflation target for 1999 is 4.0 percent.

2. Exchange Rate Policy

Under the "diagonal" exchange rate system introduced in 1991, the shekel floats within a pre-defined target zone against a basket of five currencies: the U.S. Dollar, Yen, Deutsche Mark, Pound Sterling, and French Franc. (The DM and French Franc are to be replaced by the euro as of January 1, 1999.) The slope, or pre-set rate of depreciation, of the zone is roughly equal to the expected inflation gap between Israel and its main trading partners. In August 1998, the slope of the lower (most appreciated) edge of the target zone was set at two percent per year, while that of the upper (most depreciated) limit remained at six percent. The width of the band, approximately plus or minus fifteen percent from the midpoint as of mid-1998, thus increases over time. As a matter of policy, the central bank does not intervene in the foreign exchange markets as long as the shekel remains within the target zone, although it is obligated to do so once the limits of the zone are reached. During the first half of 1997, for example, large-scale capital inflows caused the shekel to appreciate to the edge of its target zone. To keep the shekel within the zone, the central bank was forced to absorb the inflow of foreign currency and to sterilize the effect on domestic liquidity of such purchases through increased borrowings from the public.

Israel ended all foreign exchange controls for current transactions in 1993. In mid-1998, at the time of its fiftieth anniversary celebrations, Israel ended almost all of its remaining capital controls, except for limits on Israeli institutions' foreign investments and on access by non-Israelis to longer-term derivatives in the domestic market.

3. Structural Policies

Over the past decade, Israel has gradually reduced the degree of government involvement in and control over the economy while increasing the influence of domestic and international competition. Israel signed a Free Trade Agreement with the United States in 1985 and has similar agreements with the EU, the EFTA, and seven other countries. In addition, since 1991 Israel has been unilaterally reducing tariffs on imports from countries with which it does not have trade agreements. This policy of increasing exposure to international competition has led to a significant restructuring of Israeli industry, causing job losses in such traditional light manufacturing sectors as shoes and textiles.

Significant reforms, with important commercial implications for U.S. companies, are being undertaken in the telecommunications sector. In 1997, two private consortia, each with a U.S. firm as a participant, began offering international telephone service in competition with the established government-owned company; prices for international calls fell by as much as 80 percent. In October 1998, a third private company began offering cellular telephone service. Further liberalization of the telecommunications sector is planned for 1999, when the domestic market is to be opened to competition.

Israel's long-stalled privatization program came to life in 1997, when the government raised almost $3 billion from the sale of shares in government-owned companies and banks, more than twice its planned target for the year. The most important transaction of that year was the sale, to a U.S.-Israeli investor group, of a controlling 43-percent stake in Bank Hapoalim. Bank Hapoalim is Israel's largest bank and controls an estimated eight percent of the economy through its extensive holdings in Israeli industry. The pace of privatization slowed in 1998; receipts for the first ten months of the year totaled just over $1 billion. The government decided in 1998 to retain majority control of the state airline El Al; the sale of 49 percent of El Al's stock is now planned for 1999.

In the energy sector, a U.S.-based company has been awarded the first contract for the construction of a privately-operated independent electric power generating plant. In the future, under current law, up to ten percent of Israel's electricity will be generated by such independent producers; another ten percent of Israel's power needs could be met by imports. Israel is also designing its first natural gas importation and distribution system, a sector that holds promise for U.S. energy companies.

4. Debt Management Policies

From 1985, at the time of Israel's stabilization program, to the end of 1997, the ratio of Israel's net foreign debt to GDP declined from 73 percent to 18 percent, as the country's financial position gradually improved. The gross foreign debt of the public sector totaled $27.3 billion as of June 1998, all of it medium to long-term, and much of it guaranteed by the U.S. Government. Israel borrowed $9.2 billion between 1993 and 1998, for example, in bonds guaranteed by the United States intended to assist with the absorption of the immigrants from the former Soviet Union. The external liabilities of the banking system and non-financial public sector brought Israel's total gross foreign debt to $53.8 billion as of mid-1998. After netting out foreign assets of $36.3 billion, the country's net debt stood at $17.5 billion.

Anticipating the end of the U.S. loan guaranty program, the government began in 1995 to tap the international bond markets under its own name. Thus far, it has made successful offerings in the U.S., European, and Japanese bond markets.

5. Aid

U.S. assistance to Israel for fiscal year 1999 includes $1.86 billion in military aid, of which almost $1.4 billion is earmarked for procurement from the United States. U.S. aid also includes a $1.08 billion cash grant, $70 million for the Jewish Agency to assist with the absorption of new immigrants, and various forms of support for military R&D, notably for missile defense.

6. Significant Barriers to U.S. Exports

With the exception of some categories of agricultural produce and processed foods, all duties on products from the United States were eliminated under the 1985 United States-Israel Free Trade Area Agreement (FTAA) by January 1, 1995. The FTAA liberalized and expanded the trade of goods between the United States and Israel, and spurred discussions on freer trade in services, including tourism, telecommunications, and insurance.

Israel ratified the Uruguay Round Agreement on January 15, 1995. Israel became a member of the World Trade Organization on April 21, 1995 and implemented the WTO regime on January 1, 1996.

The U.S.-Israel FTAA allows the two countries to protect sensitive agricultural subsectors with nontariff barriers including import bans, quotas, and fees. These limitations have been carried forward into the WTO regime. Most quantitative limits have been translated into Tariff Rate Quotas (TRQs), while items previously banned now bear prohibitively high tariffs or fees that make imports of such goods uncompetitive with domestic production. The principal U.S. goods affected by these measures include poultry and dairy products, fish, and most fresh produce.

In late 1996, the United States and Israel agreed on a five-year program of agricultural market liberalization. The agreement covers all agricultural products and provides for increased access during each year of the agreement via TRQs and reductions in tariff levels for a significant number of U.S. goods. Despite an Israeli commitment to issue all TRQ licenses for a given year no later than October 31 of the previous year, there continue to be substantial delays in the licensing of U.S. products.

Israel has two unique forms of protection for locally produced goods. The first of these is "Harama," meaning "uplift," which is applied at the pre-duty stage to the CIP value of goods to bring the value of the products to an acceptable level for customs valuation. Israel calculates import value according to the Brussels Definition of Value (BDV), a method that tolerates uplifts of invoice prices. For purposes of calculating duty and other taxes, the Israeli Customs Service arbitrarily uplifts by two to five percent the value of most products imported by exclusive agents, and by 10 percent or more for other products. Israel is not a signatory to the GATT Valuation Code, although it has expressed its intention to become one.

The second uniquely Israeli form of protection is called "TAMA," a Hebrew acronym standing for additional quota percentage. TAMA is a post-duty uplift designed to convert the CIF value plus duty to an equivalent wholesale price for purposes of imposing purchase tax. Coefficients for calculation of the TAMA vary from industry to industry and from product to product.

In addition, purchase taxes that range from 25 to 95 percent are applied to goods ranging from automobiles to some agricultural and food items. Israel has eliminated or reduced purchase taxes on many products including consumer electronics, building inputs, and office equipment. Where remaining, purchases taxes apply to both local and foreign products. However, when there is no local production, the purchase tax becomes a duty-equivalent charge.

Israel has reduced the burden of some discriminatory measures against imports. Although Israel agreed in 1990 to harmonize standards treatment, either dropping health and safety standards applied only to imports or making them mandatory for all products, implementation of this promise has been slow. Enforcement of mandatory standards on domestic producers can be spotty, and in some cases (e.g., refrigerators, auto headlights, plywood, and carpets) standards are written so that domestic goods meet requirements more easily than do imports. In September 1998, Israel amended its packaging and labeling requirements to allow non-metric packaging as long as information on pricing in standard metric units is provided. This change should facilitate the entry of U.S. food products packaged in non-metric sizes. Israel has agreed to notify the United States of proposed new mandatory standards to be recorded under the GATT. The Standards Institute of Israel is proposing a bilateral Mutual Recognition Agreement of Laboratory Accreditation with the United States that could result in the acceptance of U.S.-developed test data in Israel. The proposed program would eliminate the need for redundant testing of U.S. products in Israel to ensure compliance with mandatory product requirements.

The government actively solicits foreign investment, including in the form of joint ventures, and especially in industries based on exports, tourism, and high technology. Foreign firms are accorded national treatment in terms of taxation and labor relations and are eligible for incentives for investments in priority development zones after receiving the approval of the Ministry of Industry and Trade. The incentive program provides grants of up to twenty percent of the amount of capital invested and tax benefits for investments in the development priority regions. There are generally no restrictions on foreign ownership, but a foreign-owned entity must be registered in Israel. Profits, dividends, and rents can generally be repatriated without difficulty through a licensed bank. About 100 major U.S. companies have subsidiaries in Israel. Investment in regulated sectors, including banking, insurance, and defense-related industries, requires prior government approval.

Israel has one free trade zone, in the town of Eilat. In addition, there are three free ports: Haifa, Ashdod, and the port of Eilat. Enterprises in these areas may qualify for special tax benefits and are exempt from indirect taxation.

Israel is a signatory to the Uruguay Round Procurement Code, which provides wide coverage of Israeli Government entities to enable more open and transparent international tendering procedures. While some government entities notify the U.S. Government of tenders valued at over $50,000, many do not, and the notices that are received frequently carry short deadlines. Moreover, U.S. suppliers are locked out of Ministry of Defense food tenders for the army and other security forces. Complex technical specifications and kosher certification requirements discourage foreign participation.

The government frequently seeks offsets (subcontracts to Israeli firms) of up to 35 percent of total contract value for purchases by ministries, state-owned enterprises, and municipal authorities. Failure to enter into or fulfill such industrial cooperation agreements (which may involve investment, co-development, co-production, subcontracting, or purchase from Israeli industry) may disadvantage a foreign company in government awards. Although

Israel pledged to relax offset requests on civilian purchases under the FTAA, Israeli law continues to require such offsets. Israeli Government agencies and state-owned corporations not covered by the Uruguay Round Government Procurement Code follow this "Buy Israel" policy to promote national manufacturers.

Israeli law provides for a 15 percent cost preference to domestic suppliers in many public procurement purchases, although the statute recognizes the primacy of Israel's bilateral and multilateral procurement commitments. The preference for local suppliers can reach as high as 30 percent for firms located in Israel's priority development areas.

In addition to its GATT multilateral trade commitments and its FTAA with the United States, Israel also has free trade agreements with the European Union, Canada, the Czech Republic, Slovakia, Turkey, Hungary, Poland, Slovenia, and the EFTA states. It also has a preferential trade agreement with Jordan. With respect to all other countries, Israel has substituted steep tariffs for nontariff barriers previously applied and is gradually reducing those tariffs. Israel's import liberalization program and negotiation of new free trade agreements have diluted U.S. advantages under the bilateral FTAA.

As part of the Middle East Peace Process, Israel has granted duty free access to its market for 50,000 tons of fresh and processed agricultural products from Jordan. It has also committed itself to allowing unlimited access for agricultural produce from the Palestinian Authority. This preferential access reduces the competitiveness of U.S. products in the Israeli market.

7. Export Subsidies Policies

The U.S.-Israeli FTAA included an agreement to phase out the subsidy element of export enhancement programs and to refrain from new export subsidies. Israel has already eliminated grants, except in the case of agricultural export and import substitution crops. In 1993, Israel eliminated the major remaining export subsidy, an exchange rate risk insurance scheme which paid exporters five percent on the FOB value of merchandise. Israel still retains a mechanism to extend long-term export credits, but the volumes involved are small, roughly $250 million. Israeli export subsidies have resulted in past U.S. antidumping or countervailing duty cases. Israel has been a member of the GATT Subsidies Code since 1985.

Israel's Parliament, the Knesset, passed legislation in 1994 authorizing the creation of Free Processing Zones (FPZs). Under the terms of the law, qualifying companies operating in the FPZs would be exempt from direct taxation for a twenty-year period, and imported inputs would be free from import duties or tariff or most health and safety regulations generally in effect throughout Israel. Companies in FPZs would also be exempt from collective bargaining and minimum wage requirements, although subject to other labor law. The legislation was originally intended to promote investment in export-related industries, but the wording of the legislation as passed does not limit applicant companies to exporters or providers of services to overseas clients. Accordingly, the FPZs do not violate the U.S.-Israel FTAA export subsidies commitment. As of November 1998, no FPZs had yet been established, although one had been proposed for the Beer Sheva region.

8. Protection of U.S. Intellectual Property

Israel is a member of the World Trade Organization (WTO), and projects that it will be in compliance with its commitments under the Trade Related Aspects of Intellectual Property (TRIPS) Agreement by January 1, 2000. Israel is a member of the World Intellectual Property Organization (WIPO), and is a signatory to the Berne Convention for the Protection of Literary and Artistic Works, The Universal Copyright Convention, the Paris Convention for the Protection of Industrial Property, and the Patent Cooperation Treaty. Israel is also a member of the International Center for the Settlement of Investment Disputes (ICSID) and the New York Convention of 1958 on the recognition and enforcement of foreign arbitral awards.

In April 1998, the U.S. Trade Representative placed Israel on the "Special 301" IP Priority Watch List due in large part to U.S. concern over an increase in illegal copying and sale of video and audio recordings. In June 1998, USTR submitted an "Action Plan" to the Government of Israel addressing outstanding US concerns. Specific concerns include increasing piracy levels of cable television transmissions, audio and video cassettes, compact disks, and computer software. Also, Israel currently has an antiquated Copyright Law which, together with the low priority given to IPR enforcement by the authorities, has allowed an upsurge in piracy. A revised Copyright Law, with updated IPR requirements, has been under review for a number of years; it has not yet been submitted to the Knesset. The proposed legislation would include enhanced rights of distribution in connection with rental rights and imports of copyrighted materials. Rental rights would include all protected works, including sound recordings, cinematographic works, and computer programs. A Cable Broadcast Law is also in preparation.

Current Israeli patent law contains overly broad licensing provisions concerning compulsory issuance for dependent and nonworking patents. A draft revision of Israel's Patent Law has been in preparation for several years; the revised law would upgrade patent protection to TRIPs standards and would eliminate compulsory licensing. In addition, revised laws are under consideration for protection of industrial designs, trademarks, and integrated circuits.

In February 1998, the Knesset passed a separate amendment to the Patent Law which will allow nonpatent holders to manufacture limited quantities of patented pharmaceutical products prior to the expiration of patent rights in order to submit data to foreign and Israeli health authorities to gain marketing approval. The amendment also provides for a limited extension of the patent term for pharmaceutical products. The United States unsuccessfully objected to the amendment and urged that Israel model its law on the comparable provision of U.S. law. Israel is also considering legislation which would substantially weaken patent protection by permitting importation of patented pharmaceutical products from non-rightholders. The United States has urged Israel not to enact the proposed legislation due to its adverse impact on the rights of U.S. patent holders.

9. Worker Rights

a. The Right of Association: Israeli workers may join freely established organizations of their choosing. Most unions belong to the General Federation of Labor (Histadrut) and are independent of the government. In 1995, Histadrut's membership dropped sharply after the federation's links with the nation's largest health care fund were severed. A majority of the workforce remains covered by Histadrut's collective bargaining agreements. Non-Israeli workers, including nonresident Palestinians from the West Bank and Gaza who work legally in Israel, are not members of Israeli trade unions but are entitled to some protection in organized workplaces. The right to strike is exercised regularly. Unions freely exercise their right to form federations and affiliate internationally.

b. The Right to Organize and Bargain Collectively: Israelis fully exercise their legal right to organize and bargain collectively. While there is no law specifically prohibiting antiunion discrimination, the Basic (i.e., quasi-constitutional) Law against discrimination could be cited to contest discrimination based on union membership. There are currently no export processing zones, although the free processing zones authorized since 1994 would limit workers' collective bargaining and minimum wage rights.

c. Prohibition of Forced or Compulsory Labor: Israeli law prohibits forced or compulsory labor for both Israeli citizens and noncitizens working in Israel.

d. Minimum Age for Employment of Children: Children who have attained the age of 15 and who remain obligated to attend school may not be employed, unless they work as apprentices under the terms of the apprenticeship law. Nonetheless, children who have reached the age of 14 may be employed during official school holidays. The employment of children aged 16 to 18 is limited to ensure adequate time for rest and education. Ministry of Labor inspectors are responsible for enforcing these restrictions, but children's rights advocates contend that enforcement is unsatisfactory, especially in smaller, unorganized workplaces. Illegal employment of children does exist, probably concentrated in urban light industrial areas.

e. Acceptable Conditions of Work: The minimum wage is set by law at 47.5 percent of the average national wage, updated periodically for changes in the average wage and in the consumer price index. Union officials have expressed concern over enforcement of minimum wage regulations, particularly with respect to employers of illegal nonresident workers. Along with union representatives, the Labor Inspection Service enforces labor, health, and safety standards in the workplace. By law, the maximum hours of work at regular pay are 47 hours per week (eight hours per day and seven hours before the weekly rest). The weekly rest must be at least 36 consecutive hours and include the Sabbath. Palestinians working in Israel are covered by the law and collective bargaining agreements that cover Israeli workers.

f. Rights in Sectors with U.S. Investment: Worker rights in sectors of the economy in which U.S. companies have invested are the same as described above.

Extent of U.S. Investment in Selected Industries -- U.S. Direct Investment Position Abroad on an Historical Cost Basis **--** 1997

(Millions of U.S. Dollars)

Category		Amount
Petroleum		49
Total Manufacturing		1,582
Food & Kindred Products	89	
Chemicals & Allied Products	53	
Primary & Fabricated Metals	(1)	
Industrial Machinery and Equipment	(1)	
Electric & Electronic Equipment	1,062	
Transportation Equipment	5	
Other Manufacturing	111	
Wholesale Trade		94
Banking		0
Finance/Insurance/Real Estate		344
Services		112
Other Industries		105
TOTAL ALL INDUSTRIES		2,286

(1) Suppressed to avoid disclosing data of individual companies.

Source: U.S. Department of Commerce, Bureau of Economic Analysis.